

Notes for F.O.M.C. Meeting
May 22, 1984

Sam Y. Cross

Since your last FOMC meeting the dollar has risen by 6 percent against the European currencies and 4 percent against the Japanese yen. It has regained most of the decline registered in February and early March, and now stands only a few percentage points below the highs of last January.

The dollar started rising right after the last FOMC meeting, and the rise continued through most of the period. The main factor buoying the dollar was the fresh evidence of robust expansion in the U.S. economy. The prospect of heavy private credit demands, along with continuing large government financing needs, led exchange market participants to expect U.S. interest rates to be under upward pressure, perhaps strong upward pressure, and the dollar moved upward in response.

The rises in U.S. interest rates which occurred were not equaled by increases elsewhere. In the Euromarkets, differentials in favor of the dollar over both mark- and yen-denominated deposits increased by about 1 percentage point and ranged between 5 and 6 points at the end of the period. These widening interest rate differentials, at a time when price data showed little or no acceleration of

U.S. inflation, appear to have restored the dollar's attractiveness for investment. The deterioration in the long term credit markets both in the U.S. and abroad, associated with uncertainties about the interest rate and economic outlook, has led many investors to liquidate long-term fixed-rate securities and park funds temporarily in high yielding short term dollar instruments. And the talk about portfolio shifts out of dollars that was so prevalent earlier in the year, has subsided.

There were also factors tending to depress investor interest in major foreign currencies, particularly the mark and the yen. Labor problems in Germany raised questions about the sustainability of that country's outstanding industrial performance. Recently, the yen declined reflecting Japan's particular dependency on the Persian Gulf and concern about the choking off of oil supplies from that region. In both countries, recent weakness in stock prices appears to have been associated with renewed inflows into U.S. equities.

With the German mark weakening during much of the intermeeting period, pressures against the other EMS currencies subsided. Their central banks took advantage of the opportunity to rebuild official reserves, and to reduce domestic interest rates in some cases so as to encourage economic recovery.

In April as the dollar continued to move higher, the Bundesbank sold dollars occasionally and sometimes in size to resist the dollar's rise. In early May the Bundesbank stepped up its intervention, and on May 10 enlisted the cooperation of several other European central banks in coordinated dollar sales of nearly

Following that day's operations, the dollar eased back against the European currencies for several days. That easing reflected some wariness in the market that the central banks might be gearing up for major and concerted intervention to push the dollar lower. In addition, it reflected some skittishness that developed in the exchange markets over the emerging funding problems of Continental Illinois and also concerns over the effect of rising interest rates on heavily indebted LDCs. These developments were seen in the exchange markets as possible constraints on U.S. monetary policy. Today the dollar is slightly below the levels reached in early May against the major currencies.

There were no Treasury or Federal Reserve operations during the period. There was an arrangement, announced at the end of March, under which a temporary bridging credit of \$500 million was provided to the Government of Argentina to enable that country to repay certain bank interest arrears while it negotiates with the IMF on an adjustment program. Within the credit package, the Governments of Mexico, Venezuela, Brazil and Colombia provided with an understanding that after Argentina signs a letter of intent with the IMF, the U.S. Treasury will provide \$300 million in

temporary swap credits which can be used to repay the four Latin American lenders. Any credit provided by the Treasury, in turn, will be repaid from Argentina's IMF drawings. This arrangement was proposed by the Mexican authorities, and we regard it as a very constructive move, designed to encourage agreement between Argentina and the IMF. Discussions are still continuing between Argentina and the IMF on an adjustment program, and also between Argentina and the commercial banks on a rescheduling and financing agreement.

May 21, 1984

Mr. Sternlight made the following statement:

Domestic open market operations during the past inter-meeting interval were driven by a huge run-up and then sharp decline in Treasury balances at the Federal Reserve. Further complications arose in the final two weeks of the period because of the huge rise in discount window borrowing by Continental Illinois National Bank, which faced severe funding problems. Throughout the period the Desk was aiming essentially for a steady degree of restraint on bank reserve positions, about unchanged from the degree of reserve availability prevailing shortly before the late March meeting, and deemed to be consistent with the Committee's preferred growth rates for monetary aggregates for the March-to-June period. Taken together, the monetary aggregates seemed to be reasonably on track. Questions about the appropriate seasonal adjustments made the data for M1 difficult to interpret, although by mid-May it looked as though M1 was coming back to around the middle of its annual growth range after slipping quite low in its range in late April. M2 seemed to grow in the lower part of its annual range while M3 was pushing a little over the upper bound of its range. Notwithstanding the approximately steady reserve pressures sought during the period—associated with seasonal and adjustment borrowing of \$1 billion and excess reserves of \$600 million—most market interest rates increased sharply.

The Federal funds rate edged up irregularly through most of the period, advancing from an average ranging around 10 percent in the latter half of March to roughly 10 1/4 percent up to late April

and closer to 10 1/2 percent from late April to mid-May. The rise reflected the discount rate increase in early April and then particular reserve stringencies when the Treasury balance was peaking in late April and early May. In the last few days the rate fell off again to the 9 - 10 percent area reflecting the bulge in reserves produced by Continental's borrowing, not all of which the Desk mopped up immediately.

In the first two maintenance periods, nonborrowed reserves came in below path and borrowings somewhat above. In the April 11 period there was substantial discount window borrowing possibly in anticipation of a discount rate hike; this produced an abundance of reserves and Desk action to meet the path in full would have caused a misleading over-abundance. In the April 25 period, the undershoot resulted from an inability to provide as many reserves as had been intended, as Treasury balances soared on the final day. Both borrowed and nonborrowed reserves were close to path in the May 9 period, but fresh problems arose in this final period--the one ending May 23--as borrowing began to be inflated by Continental's large-scale use of the window. While the path was not formally changed because of this special borrowing, the Account Management increasingly regarded the special borrowing as closely akin to nonborrowed reserves, and therefore aimed in effect for an undershoot of the formal path.

To meet the huge reserve need occasioned by the run-up in Treasury balances at the Federal Reserve from a customary \$3 billion in early April to over \$16 billion late in that month, the Desk used

a combination of bill and coupon issue purchases in the market, bill purchases from foreign accounts, and both System and customer-related repurchase agreements. At the peak point at the end of April, the Desk had added nearly \$6.4 billion to outright System holdings, making use of the enlarged leeway approved by the Committee. As the Treasury balance dropped, and later as the special borrowing augmented reserves, the System sold bills to foreign accounts and ran off bills in several auctions. For the whole period, outright holdings were up a net of just \$2.1 billion, including \$1.5 billion in Treasury coupon issues and the rest in bills. Repurchase agreements were used heavily in late April as Treasury balances peaked, but also at other times to smooth out reserve flows. Matched sales were employed on the first day, and then more extensively in the last few days to help cope with the bulge in reserves from Continental's borrowing.

The steep rise in market interest rates since late March rested on several factors, but chiefly the press of heavy credit demands from the private sector, augmented by unrelenting Treasury demands. A number of market observers have commented that the long-awaited clash of private and public sector demands is now here and is producing its expected result. In the background, the business news has continued robust. Market participants discounted signs of weakness in the data for March as partly weather-related, while the expected bounce-back in data for April has at least equaled expectations. The market remains skeptical about Congressional action to trim the deficit--questioning whether

it will be enough in total and particularly whether it will be enough in the next year or so to be of significant help near-term. Inflation is seen as not bad at the moment but prospectively troublesome as the economic expansion continues and takes up slack in productive capacity and employment. The flat performance of narrow money supply in April gave only modest comfort, being widely attributed to seasonal adjustment problems, while there is some concern that growth in May could more than offset the earlier weakness.

Against this background, investors had minimal appetite for intermediate and longer term issues, so that sizable new Treasury coupon issues had to be crammed into an exceptionally unreceptive market. As auctions approached, market rates backed up to levels where dealers anticipated that investors might have an interest, but time and again that appetite failed to develop and rates had to move still higher before supplies could be moved off the street. For the whole interval, Treasury yields on intermediate and longer issues rose about 80-100 basis points. Thirty-year Treasury bonds, which yielded around 12 1/2 percent in late March, pushed up to about 12 7/8 percent by the time the Treasury mid-quarter financing was announced in early May. The new bonds were actually auctioned at 13.32 but in the poor after-market sold off to yield as high as 13.75 - 80 briefly before backing down again to about 13 1/2 percent by the end of the period. In the course of these rate moves, some dealers have taken painful losses, although our tracking of the primary dealers does not suggest that the losses have been beyond

their capacity. The liquidation of Marsh-McLennan's large positions added to market supplies at an inopportune time. Two small non-reporting dealer firms, Lion Capital Group and RTD Securities, filed for bankruptcy, leaving a wake of problems in the repo market.

Rate moves were more moderate in the Treasury bill area, especially in the case of short bills which showed little net change or even some declines for the very shortest maturities. This pattern reflected the Treasury's sizable bill paydowns, engineered in order to provide debt limit room to accommodate the regular schedule of intermediate and longer term issues. Also, in the latter part of the period, the lower rates on short bills partly reflected some flight to quality stemming from Continental's funding difficulties. In today's three-and six-month bill auctions, the average issuing rates were about 9.95 and 10.38 percent, compared with 9.76 and 9.88 percent just before the last meeting.

In contrast with the moderate rise in bill rates, bank CDs pushed up fairly substantially over the period. This partly reflected the different supply situation--paydowns of bills as against some net issuance of CDs in the latter part of the period, possibly to fund loan demands. Later, the widening differential of CDs over bills also reflected quality concerns. As we measure it, the spread of 3-month CD yields over bills widened from 43 basis points at the start of the period to a high of 137 on May 11 and a reading this morning (May 21) of about 110 basis points. Consonant with rising costs, banks raised their prime rate twice during the interval to a current level of 12 1/2 percent.

Given the press of recent events, it is difficult to gauge what monetary policy "stance" the market is attuned to at this point. Most observers probably expect to see Federal funds around 10 1/2 percent given their assessment of our recent objectives. Meantime, the intermediate and longer maturities may have gotten a bit ahead of themselves perhaps being priced to something more like an 11 percent rate even though I don't believe that such a rate is an imminent market expectation. Indeed, if anything, the current market view is that a tightening is not likely for the moment because of the Continental Illinois and perhaps the LDC situations, and there could even be a nod to the accommodative side because of these factors.

Finally, touching on developments in the Government securities market surveillance area, I'd like to inform the Committee that the Subcommittee on Domestic Monetary Policy of House Banking Committee plans to hold hearings at the end of this month on the capital adequacy of Government securities dealers. A particular focus, I understand, is to be on a proposed approach to the standards of capital adequacy that the New York Fed sent out for comment to the dealer community a few months ago. We are now in the midst of a dialogue with the dealer community on this topic.

JLKichline
May 22, 1984

FOMC BRIEFING

Economic activity on average has remained strong in recent months while inflation has held to around the same rate as last year. Since the last meeting of the Committee a good deal of information on the economy has become available, including data for March and April as well as two official readings on GNP in the first quarter. The first-quarter growth of real GNP is now reported to have been 8-3/4 percent, somewhat above the staff's last forecast of 8 percent. The staff has made only small adjustments to its projection for subsequent periods, and essentially interprets most of the available information as consistent with its earlier view on the outlook. That view is one of still strong, but moderating, growth of real GNP in the current quarter and further moderation of growth later this year.

The information on March and April for many sectors of the economy points to considerable weakening in March and a rebound in April, a pattern that seems to reflect the effects of bad weather in March and in a few cases faulty seasonal adjustment. Cutting through the monthly gyrations, in the labor market there were continuing sizable increases of employment, a very high level of the workweek, and a pickup of growth

in the labor force; faster growth of the labor force has led to an unchanged rate of unemployment of 7.8 percent since February.

Industrial production has continued to grow rapidly, averaging 1 percent per month during the March-April period, with large increases in output of business equipment, defense products, and materials and intermediate products. Given the strong start on the second quarter, a slackening in the rate of expansion of production, which is built into the forecast, would still yield growth during the second quarter of 11 to 12 percent annual rate--the same as in the first quarter. The fast growth of production has been absorbing unutilized capacity, of course, and in April capacity use in manufacturing was a little above 82 percent.

Consumers have been very willing to spend in recent months, with personal consumption expenditures up at nearly a 7 percent annual rate in the first quarter, a rate marginally above the fourth-quarter pace. The fastest growing major category of outlays has been automobiles, an item that we expect will exhibit much less growth this quarter and throughout the projection. After all, auto sales now are at high levels--the first-quarter rate was 2 million units annually above the year earlier and there are capacity constraints for the more popular

models. More generally, however, consumer spending is projected to slow as many urgent pent up demands probably have been satisfied, consumer loan rates are on the rise, and developments in other sectors point to a moderation of income growth.

In the housing market, starts declined 15 percent during March and April from the very elevated pace earlier in the year. The staff forecast implicitly has starts remaining around the recent average of 1.8 million units annual rate for the next couple of months and then drifting lower as mortgage interest rates restrain activity. In the context of current and prospective mortgage rates, residential construction activity after this quarter will be a drag on real economic growth.

Fixed investment by the business sector, however, seems sure to continue contributing in a substantial way to overall economic expansion. New commitments for equipment and structures continue to rise, and reported business plans for expansion seem consistent with the staff's forecast of a 12 percent increase during the year. In contrast, investment in inventories seems unlikely to contribute much if anything to economic growth later this year and in 1985. Inventories grew rapidly in the first quarter and aside from autos may evidence some further growth this quarter. But the level of short-term

interest rates should reinforce the desire of firms to keep inventories in line with sales. For autos, the early model changeover at some General Motors plants this quarter is expected to depress inventories, knocking about 3/4 percentage point off growth of real GNP and adding about as much next quarter.

Recent developments in the wage-price arena have been in line with the staff forecast or, especially for prices, somewhat better. Over the first four months of this year hourly earnings were up at a 4 percent annual rate, the same as last year; the forecast entails a rise in wage and price increases later this year and in 1985 as labor and product markets tighten further.

FOMC Briefing
S. H. Axilrod
5/22/84

Since the last FOMC meeting, M1 and M2 have been running quite close to the March-to-June path set by the Committee, although M1 has done so only in an erratic way, presumably the result mostly of seasonal adjustment difficulties. There have, however, been rather less expected, and in a sense, less assuring developments.

The rise in money market rates in general has been roughly in line with what might have been expected from the reserve path set following the meeting. But within the short-term rate structure, there has been a deterioration in quality spreads, particularly as judged from the spread of CD rates over bill rates. The Continental Illinois episode made all bank CDs relatively more expensive, and the guarantee offered by the FDIC has not yet occasioned any marked narrowing of spreads.

Another somewhat unexpected development, perhaps, since the last meeting has been a rise in long-term interest rates of about the same dimension as the rise in short rates--and greater than the rise in the funds rate. Some market observers conclude from the prevailing steepness of the yield curve that monetary policy is not yet sufficiently restrictive--a conclusion that would seem to depend in some part on observing that a downward sloping yield curve has normally developed at some sort of culminating point. But, however that may be, I would not interpret the recent failure of the yield curve to flatten in face of a further rise in the funds rate as somehow indicating that some additional monetary restraint has not taken hold. For that to be the case, one would have to believe that inflationary expectations have also worsened over the past few weeks

by a percentage point or so. They have probably worsened some, but I doubt to that extent given the absence of evidence in wages, commodity prices, or the foreign exchange market of incipient inflationary pressures. What I suspect is that uncertainties in general have increased--perhaps partly in response to the raft of official statements in an election year, growing doubts about whether the budget situation can or will be resolved, and various pieces of evidence that all may not be well in financial markets--so that many investors have simply decided to stay short for a while until the atmosphere clears.

The deterioration of quality spreads and rise in long-term rates in my view would, if sustained without a further worsening of inflationary expectations, have restrictive effects beyond what would be expected from changes ordinarily associated with a 1/2 point rise in the funds rate. Mortgage rates have been steadily creeping up and would be expected to rise a bit further perhaps. And at the margin banks should become more cautious lenders. However, it may well be that, given money market conditions indexed by a federal funds rate on the order of 10-1/2 percent, we could see some narrowing of quality spreads and a minor bond market rally, should we have a passage of several generally quiet weeks.

In any event, the credit market has not to date witnessed any significant lessening of credit demands. We expect a 12-1/4 percent rise in total domestic nonfinancial debt over the first quarter to be followed by a rise of about 13 percent over the second. This has been accompanied by above target growth in M3 as depository institutions have financed a good share of the credit growth.

The private debt component of the total is expected to increase at about an 11-1/2 percent annual rate in both the first and second quarters.

This would be about the same rate of increase as in the fourth quarter of 1983, but would be noticeably more rapid than over any year of the first four years of the 1980's. The relatively rapid increase has been absorbed with what seem only moderate upward real interest rate pressures since the beginning of the year because of the substantial rise in the volume of domestic saving generated by the relatively large increase in real income made possible by an economy starting well below its capacity, (as well as a recent rise in the personal savings rate), crucially supplemented by the enlarged inflow of saving from abroad.

We are projecting a substantial slowing in debt formation during the second half of the year. The question naturally arises whether such a slowing does or does not imply further interest rate increases, especially since it is unlikely that we will have sufficient growth in the volume of real saving to finance continued rapid credit growth given that the expansion of real income will be retarded as capacity limitations are approached. In that context, if real interest rates are not to rise over the period ahead, real demands must moderate. Whether they readily will or not more or less in line with the slower increase in saving depends in large part on how restrictive the present level of real interest rates may be. Our forecast of a slowing in growth of both nominal and real GNP, as the second half progresses, does assume that present market conditions are at least working in the direction of restraint, as Jim indicated with respect to housing and consumer durables.

The behavior of M1 and M2 thus far this year, which traditionally have more predictive value than M3 or credit, are not inconsistent with a slowing of the economy and of credit demands. But a principal policy question at this time would be what should be the response if M1 and

M2 were to begin accelerating relative to the Committee's desired pace. Given the restraining effects implicit in the deterioration of quality spreads and the sharp recent further rise of long-term rates, and assuming that these are not soon reversed, there is an argument for being accommodative for a time—at least for a sufficient time to determine whether or not there may be any shift toward greater demand for liquidity in an uncertain environment on the part of the public. Absent that, however, the evidence of the past few months—where it seems apparent that M1 velocity is on a fairly strong rising trend—suggests that continued moderate growth in M1 and M2 would increase the odds on a reduction in credit growth.

Perhaps I should point out, Mr. Chairman, that the suggested directive language to take account of "any unusual financial strains" in the implementation of open market operations was not meant to be necessarily interpreted as indicating any change in the Committee's basic policy thrust toward more concern with, say, interest rates or a greater willingness to accommodate money behavior; rather it was meant to provide a handle for undertaking day-to-day actions perhaps temporarily inconsistent with reserve paths should something like disorderly market conditions emerge, as they certainly threatened to at times in recent weeks. It would, if adopted as presented, be applicable whether the reserve path came to imply unchanged, higher, or lower interest rates. It would seem more likely to be relevant, of course, should higher rates begin to emerge, either as a product of a deliberate reserve path change or, perhaps more relevantly, from a distinct further worsening in market attitudes.